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Michelle Steel: Old sales tax schemes won't work in digital age

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Buried in the scrapheap of dotcom IPOs is the story of MP3.com and how the music industry lost its fight with online piracy. An alternative to illegal Web sites such as Napster, MP3.com offered consumers a legal way to digitally access music.

Under their business model, consumers would log on, upload their legally acquired music and receive digital access to their entire music collection from anywhere in the world. The plan eliminated illegal file-sharing similar to the way online radio stations stream music today.

But even this minor change to the CD-based business model scared industry executives. They sued for copyright infringements, won the legal battle with MP3.com and in the process lost the war with music piracy. In the lawsuit's aftermath, illegal music sharing skyrocketed; CD sales plummeted.

The effects of the music industry's uncompromising strategy are still evident today. According to the International Federation of the Phonographic Industry, illegal downloads outnumbered legal ones in 2007 by a 20-to-1 margin. Old strategies don't always work with new technology.

Sadly, California lawmakers are poised to repeat this same digital download mistake with taxes.

Assemblyman Charles Calderon, D-Whittier, has introduced legislation to expand California's sales tax to digital products. This "iTax" threatens California's overall tax base by imposing a new tax on high-tech companies.

If you download a song on iTunes, you know the purchase is exempt from sales taxes. That's because the law strictly limits sales and use taxes to tangible personal property. Digital products are considered intangible and thus not subject to tax.

Assembly Bill 1956 would require the Board of Equalization to apply California's 7.25 percent sales and use tax to all digital products, including music, movie, ring tone and software downloads.

Similar to the music industry's piracy lawsuits, the bill's proponents appeal to fairness. As the bill's author recently asked, "Should we ignore products that would otherwise be taxed if they were in a tangible form?"

At first glance, the argument seems reasonable. The California Legislative Analyst's Office estimates that since 1981 California's sales tax base has declined by 10 percent.

However, an old-style tax code won't work with new technology. The Internet's pervasive nature allows anyone in the world to transfer digital products. Online media stores could easily create a separate entity out of state (or even out of the country), thereby avoiding sales taxes altogether. Under such a situation, California taxpayers would be obligated to report those purchases individually and pay the "honor system enforced" use tax, which has a 99.8 percent noncompliance rate.

Because of the problems with use-tax collection, Golden State retailers would be at a competitive disadvantage to out-of-state companies. It's become a tired cliché that tax increases cause businesses to leave the state, yet this case is unique. Digital goods don't require a massive manufacturing plant or entire office complex. Moving out of state could be as easy as setting up a room full of computer servers.

Moreover, new taxes encourage consumers to return to their nasty habit of illegally downloading music. Consumers are finally buying digital music legally. This month, Apple's iTunes surpassed Wal-Mart as the No. 1 music retailer in the United States. Analysts predict that digital music sales will overtake conventional music sales by 2010, if not sooner.

The digital product revolution is here to stay, and California lawmakers have an important decision to make. California can try to close its multibillion dollar budget deficit by applying old manufacturing-based tax laws to e-commerce, or by embracing the digital revolution with its high-paying jobs and income, property, capital gains and corporate tax revenue.

The music industry proved once before that old business models don't work with new technology. With an $8 billion budget deficit, California cannot take a chance that tax laws are any different.